IN THE

UNITED STATES COURT OF APPEALS

For The Ninth Circuit

No. 15985

ROBLEY H. EVANS and JULIA M. EVANS,
husband and wife,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Brief for Petitioners

ROSWELL MAGILL
15 Broad Street
New York, New York

LYLE L. IVERSEN
800 Hoge Building
Seattle, Washington

EDGAR BERNHARD
33 North LaSalle Street
Chicago, Illinois

DONALD J. YELLON
33 North LaSalle Street
Chicago, Illinois

JOHN C. KLETT, JR.
15 Broad Street
New York, New York

Attorneys for Petitioners

Of Counsel:

CRAVATH, SWAINE & MOORE
15 Broad Street
New York, New York

D'ANCONA, PFLAUM, WYATT & RISKIND
33 North LaSalle Street
Chicago, Illinois

FILED
1958
PAUL P. O'BRIEN, CL

McCORMICK & HENDERSON, INC., CHICAGO, ILL.

SUBJECT INDEX

PAGE

Statement of Jurisdiction 1

Statement of the Case 3

Questions Presented 7

Statute and Regulations Involved 8

Specification of Errors 8

Argument 10

Summary 10

I. The useful life of an asset for federal income tax depreciation purposes has long been defined as being the physical life of the asset, not some shorter period during which a particular taxpayer may happen to hold such asset. 11

II. The term "salvage value" of property, for depreciation purposes, means the residual, junk or scrap value of property remaining after the end of its "useful life," as defined above. It does *not* mean the estimated proceeds which may be realized from the disposition of the property when a taxpayer dispenses with it as income-producing property in his particular business long before the end of its useful life. 28

III. The respondent's redefinitions of useful life and salvage value are intended to nullify Section 117(j) of the 1939 Code. 31

PAGE

IV. The three decisions cited by the Tax Court, in its opinion below, do not support its conclusion 37

Conclusion 45

Appendix A 47

Appendix B 48

CITATIONS

Cases

Billings v. *Truesdell,* 321 U.S. 542 (1944) 17

The Colony, Inc. v. *Commissioner of Internal Revenue,* U. S. Supreme Court, No. 306, October Term, 1957, 58-2 USTC Para. 9593 (June 9, 1958) 26

Reginald Denny, 33 BTA 738 (1935) 30, 44

W. N. Foster, et al., 2 TCM 595 (1943) 21

General Securities Co., BTA Memo, CCH Dec. 12,500-D (1942), aff'd 137 F. 2d 201 (C.C.A. 6th, 1943) 19, 20

Holmes-Darst Coal Corporation, 11 TCM 122 (1952) 16

J. R. James, 2 BTA 1071 (1925), Acq. V-1 CB 3 21

Wallace G. Kay, 10 BTA 534 (1928), Acq. VII-1 CB 17 21

Lydia P. Koelling, et al. v. *United States* (D.C.D. Neb. Grand Island Div., 2/14/57, 57-1 USTC Para. 9453) 29

Max Kurtz, et al., 8 BTA 679 (1927), Acq. VII-1 CB 18 18

Leonard Refineries, Inc., 11 TC 1000 (1948), Acq. 1949-2 CB 2 39, 40

Nat Lewis, 13 TCM 1167 (1954) 21

PAGE

John A. Maguire Estate, Ltd., 17 BTA 394 (1929), Acq. IX-1 CB 34 21

Massey Motors, Inc. v. *United States,* 156 F. Supp. 516 (D.C.S.D. Fla., 1957) 21, 22, 34

J. W. McWilliams, 15 BTA 329 (1929), Acq. VIII-2 CB 34 ....41, 42, 43

Merkle Broom Co., 3 BTA 1084 (1926), Acq. V-2 CB 2 18

Philber Equipment Corporation v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3rd, 1956) 22, 23, 34

Pilot Freight Carriers, Inc., 15 TCM 1027 (1956) 23

Sanford Cotton Mills, 14 BTA 1210 (1929), Acq. X-2 CB 63 17

Southeastern Bldg. Corporation v. *Commissioner of Internal Revenue,* 148 F. 2d 879 (C.C.A. 5th, 1945), cert. den. 326 U. S. 740 (1945) 21

United States v. *Ludey,* 274 U.S. 295 (1927) 38

West Virginia & Pennsylvania Coal & Coke Co., 1 BTA 790 (1925) 20, 21

Estate of B. F. Whitaker, 27 TC 399 (1956) 24

Whitman-Douglas Co., 8 BTA 694 (1927) 21

Wier Long Leaf Lumber Co., 9 TC 990 (1947), Acq. 1948-1 CB 3 (reversed on other issues, 173 F. 2d 549 [C.A. 5th, 1949]) 24

Willcuts v. *Milton Dairy Company,* 275 U.S. 215 (1927) 26

PAGE

Statutes

Internal Revenue Code of 1939
Section 23(l) 5, 7, 8, 36, 43 47
Section 117(g)(3) 36
Section 117(j) 31, 32, 33, 34, 35, 36
Section 124A 36

Internal Revenue Code of 1954
Section 168 36
Section 1231 .... 32, 33, 36
Section 1238 36
Section 6212 .... 1, 5
Section 6213 .... 2, 6
Section 7482(b)(1) 2
Section 7483 2

Bills

H. R. 8300, 83rd Cong., 2d Sess. 35
H. R. 8920, 81st Cong., 2d Sess. 34

Committee Reports

House Report No. 1337, 83rd Cong., 2d Sess. 33

Treasury Department Regulations,
Rulings and Bulletins

Bulletin "F" (Rev. Jan. 1942) 14, 15

O. D. 845, C.B. January-June 1921, page 178 14

Regulations 45, *Article* 161 12

Regulations 45, *Article* 165 13

PAGE

Regulations 103, *Section* 19.23 (l)-1,-5 13

Regulations 111, *Section* 29.23 (l)-1 ....8, 13, 14, 29, 31, 43, 47

Regulations 118, *Section* 39.23 (l)-1 14

Rev. Rul. 90, 1953-1 CB 43 31

Rev. Rul. 91, 1953-1 CB 44 31

Rev. Rul. 108, 1953-1 CB 185 16

Rev. Rul. 54-229, 1954-1 CB 124 16

Miscellaneous

American Institute of Accountants, Committee on Federal Taxation, Recommendation No. 180 on H.R. 8300, filed with the Senate Finance Committee, April 19, 1954 (Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2d Sess., on H.R. 8300, Part 3, page 1324) 35

Dickinson, "Useful Life and Salvage Value: Changing Concepts," 7 Drake L. Rev. 32 (1957) 37

Report of Business Tax Section, Division of Tax Research, U. S. Treasury Department ("Revenue Revisions, 1947-1948," hearings of December 2-12, 1947, Part 5, page 3756) 33

IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 15985

ROBLEY H. EVANS and JULIA M. EVANS,
husband and wife,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Brief for Petitioners

STATEMENT OF JURISDICTION.

Petitioners, husband and wife, filed their joint income tax returns for the years 1950 and 1951 with the Collector of Internal Revenue for the District of Washington (R. 21).

A notice of deficiency was mailed by respondent to petitioners on March 9, 1955, pursuant to Section 6212 of the Internal Revenue Code of 1954 (hereinafter called the "1954 Code"). The deficiencies determined by the respondent were for income taxes for the calendar years 1950 and 1951 in the respective amounts of $32,847.62 and $49,514.04, a total of $82,361.66 (R. 21).

On or about May 31, 1955, petitioners duly filed a petition with the Tax Court of the United States for a redetermination of the asserted deficiencies, pursuant to Section 6213 of the 1954 Code (R. 17).

By its decision rendered on February 7, 1958, the Tax Court redetermined the deficiency to be $13,191.52 for 1950 and $13,048.12 for 1951, a total of $26,239.64 (R. 34).

Pursuant to Section 7483 of the 1954 Code, petitioners filed a petition for review of the decision of the Tax Court by the United States Court of Appeals for the Ninth Circuit on March 10, 1958 (R. 96).

The office of the Collector (now Director) of Internal Revenue to whom petitioners made returns of the tax in respect of which the adjudged tax liability arose is located within the jurisdiction of this Court. This Court has jurisdiction of a review of the decision of the Tax Court herein under the provisions of Section 7482(b)(1) of the 1954 Code.

STATEMENT OF THE CASE.

(1) Petitioner's business.

During the years 1950 and 1951, petitioner Robley H. Evans (hereinafter the word "petitioner" refers to Robley H. Evans) was engaged in the business of leasing automobiles to Evans U-Drive, Inc. (hereinafter "U-Drive") at a monthly rental of $45 per automobile. U-Drive was managed by the petitioner and was engaged in the business of leasing and renting automobiles to the public. Some of U-Drive's automobiles were leased for extended periods and the rest were rented for relatively short terms, ranging from a few hours to several weeks (R. 21-22, 42-45).

Under the terms of the lease agreement between petitioner and U-Drive, petitioner was obligated to furnish U-Drive with a sufficient number of automobiles to enable it to operate and conduct its leasing and renting business efficiently. Automobiles which, from time to time, became surplus to U-Drive were returned to petitioner, who disposed of them (R. 21-22, 43-46, 64-65).

Automobiles leased by U-Drive to others for extended periods of time were purchased by petitioner as required. At the termination or cancellation of such leases, the automobiles were returned to petitioner, who sold them (R. 46, 64). When sold, such automobiles had been driven an average of 50,000 miles (R. 54). They were generally in good physical condition and state of repair at the time of sale (R. 54, 58), and petitioner could have continued to use them longer than he did (R. 80-83).

Petitioner periodically owned more automobiles than were necessary for the efficient operation of the short-term rental business of U-Drive. When this situation occurred, he would examine the cars in use and sell the number which were not needed. The oldest and least desirable automobiles were sold first (R. 47, 51, 54). When sold, such automobiles had been driven an average of 15,000 to 20,000 miles (R. 54).

(2) Factors affecting purchase and sale of vehicles by petitioner.

There was no way to predict what an automobile would bring some 18, 24 or 36 months in the future, when the lease terminated and the automobile might be disposed of (R. 65). It was impossible for the petitioner to project what the sales price of an automobile was going to be when he bought it, because he never knew when he was going to dispose of it, and could not foresee 18, 12 or even 6 months ahead, the effects of the numerous economic and other factors affecting used automobile values (R. 71).

Among these factors were strike conditions, manufacturing conditions, the development of new accessories, the advent of war and the anticipation of rationing (R. 66, 69, 71).

During the years 1950 and 1951, the petitioner disposed of certain automobiles used in his business at the respective times and for the respective prices set forth in Exhibit A to the respondent's deficiency notice of March 9, 1955 (R. 22), the petitioner having purchased these automobiles at the respective dates and for the respective prices set forth in said Exhibit (R. 22).

(3) Accounting practice as to "useful life".

Certified public accountants—partners, respectively, in the firms of Ernst & Ernst and Price Waterhouse & Co., whose experience and background stamp them as outstanding leaders in the accounting profession in the United States—testified that "useful life" has consistently meant and still means, for both accounting and federal income tax purposes, not the period of use of an asset in the hands of the taxpayer—erroneously termed by the respondent the "life" in the hands of the taxpayer—but the economic life, the general business life, of the asset in whatever hands (R. 83-91).

(4) The taxes here involved.

During the years in issue, petitioner depreciated the automobiles which he leased to U-Drive at the rate of 25% per annum without any allowance for salvage value. This rate represented a four-year useful life, and resulted in deductions in the amounts of $77,972.71 and $92,890.05 for the years 1950 and 1951, respectively (R. 22). Such amounts were deducted pursuant to the provisions of Section 23(l) of the Internal Revenue Code of 1939 (hereinafter called the "1939 Code"), applicable to the years in issue.

On March 9, 1955, respondent sent petitioner a statutory notice of deficiency pursuant to Section 6212 of the 1954 Code, alleging, among other things, that petitioner had overstated the depreciation deductions allowable with respect to automobiles which petitioner leased to U-Drive during 1950 and 1951. In the notice of deficiency, respondent recomputed depreciation for the years 1950 and 1951 in the respective amounts of $21,858.62 and $30,374.13, stating that the average useful life of automobiles in petitioner's business was not in excess of seventeen months

and the average salvage value of said automobiles was not less than $1,325.00 or the adjusted basis of said automobiles as of January 1, 1950, whichever amount was the lesser (R. 12).

In computing the rate of depreciation for automobiles leased to U-Drive in 1950 and 1951, petitioner used their physical or inherent functional life (*i.e.,* their life for general business purposes)—four years. Petitioner did not take into account any amount for salvage value, since it merely represented the residual, junk or scrap value of the automobiles after the end of their "useful life" as defined above. In his notice of deficiency, respondent claimed that the "useful life" of petitioner's automobiles should be determined not on the basis of their physical or inherent functional life but rather on the basis of the average period during which petitioner held them as income-producing property in his business (R. 12). Respondent also claimed that the salvage value of such automobiles should be determined for the years in issue by taking the average of the amounts realized by petitioner from the disposition of his automobiles during those years (R. 12).

(5) The Tax Court proceeding.

Pursuant to Section 6213 of the 1954 Code, petitioners appealed to the Tax Court for a redetermination of respondent's proposed deficiency on this issue, their petition being duly filed on or about May 31, 1955. Trial was held in Seattle, Washington, on February 5, 1957. On July 31, 1957, the Tax Court filed a memorandum opinion (R. 24-33) holding that the automobiles which petitioner leased to U-Drive during the years in issue for use under extended term leases had a useful life of three years and a salvage value of $600, and that the automobiles which petitioner leased to U-Drive for use in its short-term rentals had a

useful life of 15 months and a salvage value of $1,375. With respect to the salvage value issue, the Tax Court further held that if the ''undepreciated cost'' (apparently meaning adjusted basis) of the automobiles in service at January 1, 1950, was less than $600 and $1,375 for the respective classes of automobiles, that amount should be the salvage value of those automobiles. The Tax Court adopted respondent's definitions of useful life and salvage value with respect to petitioner's automobiles although, in the case of automobiles used by U-Drive for short-term rentals, the opinion of the Tax Court was even more adverse to the petitioner than the respondent's determination. Pursuant to that opinion, a decision was entered under Rule 50 of the Rules of the Tax Court on February 7, 1958 (R. 34), adjudging a total deficiency of $26,239.64 for the years 1950 and 1951, of which $23,139.12 is attributable to the issue here involved—petitioner's deductions for depreciation of automobiles leased to U-Drive during those years. The balance of the deficiency is attributable to issues settled by stipulation.

On March 10, 1958, petitioners filed a petition for review by this Court of the decision of the Tax Court with respect to the automobile depreciation issue.

QUESTIONS PRESENTED.

(a) Whether the term ''useful life'', as applied to automobiles used in petitioner's automobile leasing business, in computing the depreciation allowance under Section 23(l) of the 1939 Code, means (1) the physical or inherent functional life of such automobiles (*i.e.*, their life for general business purposes), a four-year life, as reported by petitioner; or means (2) an average, or other imputed, holding period of such automobiles, fifteen months or three years, as the case may be, as decided by the Tax Court; and

(b) Whether the term "salvage value", as applied to such automobiles, means (1) the residual, junk or scrap value of such automobiles after the end of their physical or inherent functional useful lives, as contended by petitioner; or means (2) the estimated proceeds from the disposition of such automobiles which may be realized by the petitioner based upon an assumed value and an assumed disposition of such automobiles before the end of their useful lives after an estimated period of use, as decided by the Tax Court.

STATUTE AND REGULATIONS INVOLVED.

The basic statute and regulations involved are Section 23(l) of the 1939 Code, and Regulations 111, Section 29.23(l)-1, promulgated thereunder. The statute and regulations are set out in full text in Appendix A to this Brief.

SPECIFICATION OF ERRORS.

The Tax Court erred:

(1) In deciding that automobiles leased by petitioner had a useful life, for depreciation purposes, based on the period during which such automobiles were held by petitioner as income-producing properties in his automobile leasing business, and in thereby deciding that:

(a) the useful life, for depreciation purposes, of automobiles leased for relatively extended periods was three years rather than four years, and

(b) the useful life, for depreciation purposes, of automobiles rented for short periods was fifteen months rather than four years.

(2) In deciding that automobiles leased by petitioner had a salvage value, for depreciation purposes, based on the proceeds realized by petitioner when he dispensed with such automobiles as income-producing property in his automobile leasing business, and in thereby deciding that:

(a) the salvage value of the automobiles leased for relatively extended periods was $600 rather than junk or scrap value,

(b) the salvage value of automobiles rented for short periods was $1,375 rather than junk or scrap value, and

(c) if, on January 1, 1950, any automobiles of either class had an "undepreciated cost" less in amount than $600 or $1,375, respectively, such lesser amount was the salvage value of such automobiles rather than junk or scrap value.

(3) In holding that there are deficiencies in income tax for the calendar years 1950 and 1951 in the respective amounts of $13,191.52 and $13,048.12.

(4) In that its opinion and decision are contrary to law and are not supported by substantial evidence.

ARGUMENT.

Summary.

Precise definition of the related terms "useful life" and "salvage value" is fundamental to a determination of depreciation for federal income tax purposes. Neither term is defined in the 1939 Code or in the regulations promulgated thereunder. In the absence of statutory or regulatory definition, the meaning of these terms must be obtained from the judicial decisions, the administrative practice of the Treasury Department and expert opinion. A thorough review of such authorities establishes that:

(1) The term "useful life" of property, for depreciation purposes, means the physical or inherent functional life of that property (i.e., the property's life for general business purposes), and not the period during which it is estimated that it will be held by a taxpayer as income-producing property in his particular business; and

(2) The term "salvage value" of property, for depreciation purposes, means the residual, junk or scrap value of property remaining after the end of its "useful life", as defined above, and not the estimated proceeds which may be realized from the disposition of the property when a taxpayer dispenses with it as income-producing property in his particular business before the end of its useful life.

Under these definitions, the automobiles in petitioner's automobile leasing business had a useful life of four years and a salvage value determinable at the end of such period.

The decision of the Tax Court in the instant case is based on erroneous definitions and applications of both terms, and for that reason it should be reversed.

Until the opinion of the Tax Court herein, judicial interpretation, administrative practice under the 1939 Code and expert opinion had long agreed that for purposes of the depreciation deduction ''useful life'' means the physical life of the property, not the intended or actual period of the taxpayer's use of the property.

Similarly, judicial interpretation, administrative practice and expert opinion agreed that ''salvage value,'' the value remaining in depreciable property at the end of its useful life, was the residual or scrap value of fully depreciated property, not the proceeds from its sale at the end of a particular holding period of a specific taxpayer.

We submit that these principles are established by unimpeached testimony elicited at the trial and by the judicial and administrative precedents cited by petitioner. The Commissioner seeks to abandon such precedents after they have been confirmed by more than 35 years of use.

I.

The useful life of an asset for federal income tax depreciation purposes has long been defined as being the physical life of the asset, not some shorter period during which a particular taxpayer may happen to hold such asset.

Petitioner's position in the case at bar with respect to the meaning of useful life is amply supported by the long history of interpretation and practical application given this phrase (1) by the Commissioner of Internal Revenue, (2) by the courts, and (3) by the accounting profession.

''Useful life'' has long been defined as the period during which an asset is physically useful for business purposes. Useful life refers to the total employment of the asset in the economy, whether by one or more users, rather than to the shorter period of its usefulness to a particular taxpayer for a given use.

It has long been recognized that the particular operating practice of a taxpayer has important effects on the physical life of an asset. Thus the particular use may shorten the total period of economic usefulness materially—usually through abnormally heavy operation or under-maintenance. To the extent that such operating practice is proved, a particular taxpayer is permitted to adjust his depreciation rate accordingly. The novel theory advanced by the Commissioner of Internal Revenue in this case, however, is not based on this proposition. The Commissioner wishes, rather, to disregard the fact that the asset has years of useful life left after the taxpayer sells it. He wants to lower an iron curtain at the end of the period of the taxpayer's use of the property, and to limit his recognition of "useful life" solely to the partial life of the assets in the hands of the first user. Such a fractional recognition of useful life is new in the tax depreciation field, as the taxpayer showed.

(a) The Commissioner's regulations.

The meaning of the term "useful life" has emerged from years of practice rather than from any clear, unambiguous statutory or regulatory language. The term is not mentioned in the depreciation provisions of the 1939 Code, the law applicable to the years here in issue, nor is it mentioned in any of the prior revenue acts.

The various and successive income tax regulations beginning with Regulations 45, Article 161 (effective for the tax years 1918, 1919 and 1920) do mention the terms "useful life" and "salvage value". Article 161 provided, in part, as follows:

" . . . The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a *consistent* plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost. . . ." (Emphasis added.)

Furthermore, Article 165 of Regulations 45 also mentioned the term "useful life" and provided, in part:

"The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice. . . . "

Similar wording, with changes not material to this discussion, continued in successive sections or articles of the various and successive income tax regulations through Regulations 103, Section 19.23(l)-1,-5 (effective for the tax years 1939, 1940 and 1941). It should be noted, however, that no further explanation or clarification appeared in any of these regulations in reference to useful life or salvage value.

We come then to Regulations 111, Section 29.23(l)-1. These regulations were in effect for the tax years 1942 through 1951, and hence are the regulations applicable to the years involved in this case. We call to this Court's attention the fact that the phrase "in the business" was *omitted* from those regulations. They provided, in part:

" . . . The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably *consistent* plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the *useful life of the depreciable property* ['in the business' *omitted*], equal the cost or other basis of the property determined in accordance with section 113. . . ." (Emphasis added.)

Regulations 118, Section 39.23(l)-1 (effective for tax years beginning after December 31, 1951) contained identical language.

It is very significant that the Commissioner's regulations in effect during the years here in issue, 1950 and 1951, did not contain the phrase *"in the business"* which was found in prior regulations. It is clear from a review of the cases hereinafter discussed, *and particularly from the respondent's position therein,* that the earlier regulations and the phrase "in the business" contained therein were not intended by respondent to limit useful life to the holding period of a particular taxpayer. We submit that probably one of the respondent's reasons for deleting the phrase "in the business" from Regulations 111, Section 29.23(l)-1 was the fact that he had consistently taken the contrary position before the courts in order to establish longer "useful lives" and consequently smaller annual depreciation deductions.

(b) The Commissioner's own pronouncements.

(i) In O.D. 845, C.B. January—June 1921, page 178, the Treasury Department took the position that the term "useful life" means "the period of time over which an asset *may* be used for the purpose for which it was acquired." (Emphasis added.) It should be noted that there are no words of limitation and that this interpretation is in terms of the usability of the asset itself for general business purposes, without consideration of whether the particular taxpayer uses it up himself or sells it before the end of such usability.

(ii) For many years before the taxable years here under review, the Commissioner had issued Bulletin "F" (Rev. Jan. 1942), setting forth the Bureau's general depreciation policy and tables of estimated lives of particular kinds of assets. Bulletin "F" is the official guide to depreciation policy and rates issued by the Commissioner of Internal Revenue. Bulletin "F" stated in the first sen-

> "The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use *of capital assets which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption* usually is gradual, extending over a period of years. *It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.*" (Emphasis added.)

Again, "useful life" is referred to in terms of physical using up of assets—their total employment in the economy —rather than their employment by an individual taxpayer.

Consistent with the practice of the accounting profession and with the regulations in effect during the taxable years here under review, the petitioner employed a useful life for his automobiles based on their normal estimated physical life. In the considerable experience of the petitioner, an automobile used in a commercial business had a useful life of four years (R. 70). Furthermore, the petitioner's experience is supported by Bulletin "F", which lists estimated useful lives of various assets. The Commissioner, in Bulletin "F", recommended to taxpayers that for depreciation purposes they assign a five-year useful life to passenger automobiles and a three-year useful life to salesmen's automobiles. Since the petitioner's automobiles were rented and leased for both purposes (R. 46, 65-66), we submit that the reasonableness of a four-year useful life is sustained by the Commissioner himself.

We wish to emphasize that it was the Commissioner of Internal Revenue who issued Bulletin "F" as a guide; and it is significant that Bulletin "F" did not suggest 12 months or 24 months as the useful life of an automobile, but *five years for passenger cars and three years for salesmen's cars.* And we cannot refrain from asking why the Commissioner of Internal Revenue did not simplify his

own task by stating, in far more simple terms and in one page instead of a pamphlet, that the useful life of a depreciable asset would be *its life in the hands of the particular taxpayer* if that indeed were his view?

The Commissioner of Internal Revenue's own bulletin shows that he deems the useful life of automobiles to be their full useful life, namely, three years and five years. As the Tax Court stated in *Holmes-Darst Coal Corporation,* 11 TCM 122, 130 (1952):

> "Petitioner [taxpayer] relies upon the respondent's [Commissioner's] Bulletin 'F', issued as a guide for depreciation deductions, wherein it is stated that a useful life of 3 years for cars used by salesmen is reasonable. While the bulletin has not the force or effect of a treasury regulation, it is presumably based on the respondent's [Commissioner's] experience over a period of years."

(iii) In Rev. Rul. 108, 1953—1 CB 185, the Commissioner referred to the practice of selling automobiles after "leasing them for substantially less than their normal useful life". He certainly was not referring to a useful life which ends when the taxpayer sells the automobile.

In Rev. Rul. 54-229, 1954—1 CB 124, again the Commissioner referred to a sale of automobiles after "leasing them for a period substantially less than their normal useful life." Again he was referring to a useful life in the petitioner's terms—in terms of inherent physical life.

Would respondent contend that his published rulings are loosely drawn, with little or no regard to the language used?

It is to be noted that this use by the Commissioner of the term "useful life" occurred—in both instances—in a context in which the question of depreciation on leased cars was expressly considered; that the rulings were con-

cerned with the very business in which petitioner was engaged during the years here under review; and that the Commissioner was equating "useful life" with the total functional life of the automobiles for business purposes despite the practice of the taxpayers involved of disposing of the automobiles well before the end of such functional usability.

These rulings, and their interpretation of useful life by the agency charged with the responsibility of administering the Internal Revenue Code, are clearly of persuasive weight under the authorities. (*Billings* v. *Truesdell,* 321 U.S. 542, 552-53 [1944]).

(c) Prior cases.

The principle that "useful life" refers to the general business life of the asset itself, and not to individual holding periods of specific taxpayers, has been recognized over a long period of years by court decisions and by the Commissioner.

(i) In *Sanford Cotton Mills,* 14 BTA 1210 (1929), Acq. X-2 CB 63, the taxpayer, a manufacturer of cotton sheeting, contested the Commissioner's reduction of the rate of depreciation of motor trucks from 33-1/3% to 20%. The taxpayer made a practice of keeping the trucks for approximately 2½ years. The Board of Tax Appeals nevertheless held that a rate of 25% was reasonable, and stated:

> "On motor trucks which cost $7,400, the respondent allowed a deduction on account of the exhaustion, wear and tear thereof at the rate of 20 per cent. It was the petitioner's custom to use these trucks for approximately 2½ years and then trade them in on the purchase price of new trucks. The usual allowance on the old trucks was $1,000 on a truck costing $5,000. A reasonable deduction on account of the exhaustion, wear and tear of trucks would be at the rate of 25 per cent." (14 BTA, at 1211.)

Thus, the Board of Tax Appeals proceeded on the basis of a four-year life, although the practice of the taxpayer was to dispose of vehicles after two and one-half years—and the Commissioner officially acquiesced in this decision.

(ii) In *Merkle Broom Co.,* 3 BTA 1084 (1926), Acq. V-2 CB 2, which concerned the proper depreciation rate for the taxpayer's fleet of automobiles used by its salesmen, the taxpayer claimed 33-1/3% per annum and the Commissioner allowed 20% per annum. The Board of Tax Appeals found that the taxpayer renewed its fleet every second year, stating:

> "The taxpayer uses in its business automobiles, such as Dodges, Hupmobiles, Buicks, and Fords. These are used by salesmen in traveling throughout the country. As a rule, automobiles are exchanged for new ones at the end of the second year." (3 BTA, at 1085.)

The Board, nevertheless, held that the proper rate for depreciation was 25%—a four-year useful life. Again the Commissioner acquiesced.

(iii) In *Max Kurtz, et al.,* 8 BTA 679 (1927), Acq. VII-1 CB 18, the taxpayer contested the Commissioner's determination of a five-year useful life for business automobiles and trucks which the taxpayer made a practice of trading in after two or three years of use. The Board of Tax Appeals found as a fact that:

> "During the years involved the partnership owned certain Ford, Dodge, and Studebaker passenger automobiles and certain automobile trucks. These cars were traded in after two or three years of use at substantial values." (8 BTA, at 681.)

Yet the Board held as follows:

> "The Board is of the opinion that, upon consideration of all the evidence, the Commissioner's allowance for exhaustion, wear and tear of automobiles at the rate of 20 per cent per annum was reasonable. . . ." (8 BTA, at 683.)

The Commissioner acquiesced in the decision.

Can it reasonably be maintained, in view of the respondent's position in these cases, that the phrase "in the business" appearing in his regulations between 1918 and 1941 was intended to limit a taxpayer's useful life for depreciation purposes to the period during which the taxpayer held the asset?

(iv) In 1942, the year in which the phrase "in the business" was deleted from the regulations, respondent attempted to compel the taxpayer in *General Securities Co.*, BTA Memo., CCH Dec. 12,500-D (1942), *aff'd* 137 F. 2d 201 (C.C.A. 6th, 1943), to depreciate automobiles used in its business over a useful life of more than the three years claimed by the taxpayer. The Board of Tax Appeals found:

> "In its business petitioner used one or two automobiles in which its agents traveled over territory located in all of the southern states. Each automobile traveled some 60,000 to 75,000 miles a year. Petitioner kept his automobiles from one to two years. When petitioner traded its cars in after one year, from a value standpoint, they had a third to a half of their original value left. The normal useful life of automobiles used by petitioner in its business was three years."

The Board allowed the taxpayer to depreciate its automobiles over the three-year life *despite its finding that the taxpayer, as a matter of practice, traded in its automobiles after one to two years' use with anywhere from one-half to one-third of their original value left.* On this issue, the Board held:

> "The final issue is whether petitioner has claimed excessive depreciation on automobiles used in its business. The sole dispute is as to the anticipated useful life of the cars, considering the strenuous use to which they were put. The only evidence on the subject was

> that of petitioner's president, who testified that the cars were only used a year or two but during that period covered from 60,000 to 150,000 miles. It was his opinion that under such circumstances the cars could not have had anticipated lives of more than three years. Since this is the sole issue, the question of cost of the assets, their age, condition, and earlier depreciation are not involved. *Cf.* Regulations 94, Article 23-1(5). There being no evidence to contradict that furnished by petitioner, we have found the facts in accordance with its claim. On this issue, petitioner is sustained."

In addition, it should be noted that the taxpayer in the *General Securities Co.* case was attempting to claim a shorter useful life of its automobiles because of abnormally heavy operation. Nevertheless, neither the parties nor the Board of Tax Appeals considered it proper to equate the automobiles' useful life with the taxpayer's one- or two-year period of ownership.

The position taken by the respondent in each of the cases discussed above clearly negatives any inference that the phrase "the useful life of the property in the business", which first appeared in 1918 in Regulations 45, Article 161, was intended by or even undertood by respondent to mean that useful life was the equivalent of a taxpayer's holding period of depreciable assets. Surely, after the phrase "in the business" has been *dropped out* of the regulation, it cannot be seriously contended that the proper interpretation of the regulation requires not only its reinsertion but that, *omitted,* it be given weight and emphasis it did not have when included.

(v) Other cases which similarly illustrate the traditional distinction between an asset's useful life and the period during which it happens to be used in a particular taxpayer's business are: *West Virginia & Pennsylvania*

Coal & Coke Co., 1 BTA 790 (1925); *J. R. James,* 2 BTA 1071 (1925), Acq. V-1 CB 3; *Wallace G. Kay,* 10 BTA 534 (1928), Acq. VII-1 CB 17; *W. N. Foster, et al.,* 2 TCM 595 (1943); *John A. Maguire Estate, Ltd.,* 17 BTA 394 (1929), Acq. IX-1 CB 34; *Nat Lewis,* 13 TCM 1167 (1954); and *Whitman-Douglas Co.,* 8 BTA 694 (1927). These cases all support the position that the "useful life" of property, for depreciation purposes, refers to the period of the asset's functional, physical usefulness, rather than to just the period of its use by individual taxpayers. And the principle underlying these cases is succinctly stated in *Southeastern Bldg. Corporation* v. *Commissioner of Internal Revenue,* 148 F. 2d 879 (C.C.A. 5th, 1945), cert. den. 326 U.S. 740 (1945), as follows:

> "In the case of depreciation, the deduction is granted for the reason that Congress realizing that *business property becomes worn out gradually through usage and lapse of time,* provides that an allowance should be made whereby a taxpayer could secure a return of his original costs by the expiration of the *useful or economic life of the property.*" (148 F. 2d, at 880; emphasis added.)

(d) Recent decisions.

In the recent case of *Massey Motors Inc.* v. *United States,* 156 F. Supp. 516 (D.C. S.D. Fla., 1957), the taxpayer, an automobile dealer, retained company cars both for its own use and for lease to other businesses. The taxpayer's depreciation of its company cars of both classes on the straight-line method, on the basis of a useful life of three years, was upheld by the court. The court clearly acknowledged the taxpayer's practice of selling its company cars *before the end of their useful lives*:

> "The decision to sell the company cars was made by plaintiff's management on the economic facts of whether holding a car longer would appreciably reduce

the sales price for it. *The plaintiff followed the practice of disposing of all company and leased cars either immediately before or as soon after a model change as was practicable.* Plaintiff's management deemed it advisable to have company personnel in current model company cars. Plaintiff also disposed of leased vehicles during the year if a particular unit had been run approximately 40,000 miles. Company cars were also removed from service when they had been run approximately 10,000 miles without regard to model change.'' (156 F. Supp., at 520; emphasis added).

The Court held:

> ''The plaintiff depreciated its company cars on the straight-line method, utilizing an estimated *useful life of 36 months, which the Court finds to be a reasonable and fair rate.*
>
> ''. . .
>
> ''The plaintiff is entitled to the depreciation claim [ed] on its company cars . . . in its 1950 and 1951 returns under Section 23 (l) of the 1939 Code.'' (156 F. Supp., at 520 and 522; emphasis added).

The situation of the petitioner in the case at bar and that of the taxpayer in the *Massey Motors* case are virtually identical as to the question here in issue. The tax years, the applicable law, the use of the vehicles, the practice of vehicle disposal and the depreciation claimed are substantially the same.

Philber Equipment Corporation v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3rd, 1956), provides recent judicial corroboration (and respondent's own admission) of the position that a taxpayer's holding period of leased vehicles does not determine their useful lives. There, the issue was whether profit on the sale of vehicles was capital gain, or was taxable at ordinary rates—that is, whether the taxpayer held the vehicles primarily for sale to customers. The taxpayer (which was engaged in the business of leasing vehicles) regularly dis-

posed of vehicles after the end of one-year lease terms. The court stated in this regard:

> "Taxpayer knew that when equipment was purchased it would probably be able to rent the equipment for *a period substantially less than its useful life,* and sale of the equipment would follow expiration of a lease." (237 F. 2d, at 130; emphasis added.)

And respondent specifically argued this point in his brief in the *Philber* case, where he stated:

> "Because of existing conditions taxpayer knew when it purchased equipment that it would likely be able to rent such equipment only for *a period that was substantially less than its useful life.*" (Brief for Respondent, p. 5, *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* C.A. 3rd, Docket No. 11,860; emphasis added.)

And again, at page 11 of respondent's brief in that case, respondent stated:

> ". . . all of the leases involved were only for a one-year term, *a period substantially less than the useful life* of this type of equipment as its resale in the tax years and re-lease in later years demonstrates." (Emphasis added.)

It thus appears that, as late as 1956, *in the Philber case, the Commissioner himself continued to apply the unambiguous, consistent and commonly understood meaning to the term "useful life".*

We refer the Court also to *Pilot Freight Carriers, Inc.,* 15 TCM 1027 (1956), in which the taxpayer's tractors and trailers were shown to have been held by the taxpayer for average periods of 38 months and 32.6 months, respectively. Nonetheless, the Commissioner contended that their useful lives were five years and six years, respectively. The court held that the useful lives of such tractors and trailers, for

depreciation purposes, were four years and five years, respectively, as contended by the taxpayer. In that case, as in the case at bar, the respondent argued that the useful lives claimed by the taxpayer for such property were erroneously computed because, upon sale by the taxpayer, the latter received "amounts largely in excess of the depreciated cost thereof." The court rejected that argument, citing, from *Wier Long Leaf Lumber Co.*, 9 TC 990 (1947), Acq. 1948-1 CB 3 (reversed on other issues, 173 F. 2d 549 [C.A. 5th, 1949]), this principle:

> "The sole fact therefore in any specific situation that a given price is received for articles not fully depreciated throws no light on the effect upon the depreciation allowance." (9 TC, at 999.)

In *Estate of B. F. Whitaker*, 27 TC 399 (1956), the taxpayer wished to depreciate fully his race horse in the year in which it broke a leg and was no longer useful for race horse purposes. The court denied the claim, equating useful life with the period over which an asset may be subject to depreciation in the sense of physical exhaustion and not with the period during which an asset is held by a particular taxpayer for a particular use. The Court stated:

> "The petitioner computed the depreciation on Baby Jeanne on a straight-line basis. To be entitled to additional depreciation when computing it on a straight-line basis, the petitioner must show that additional *exhaustion, wear and tear* have shortened the previously estimated useful life of the asset. * * * The petitioner has shown the useful life of Baby Jeanne as a race-horse had been shortened. But the useful life has been shortened by an accidental injury, not by depreciation, *i.e., exhaustion, wear, and tear.*" (27 TC, at 406; emphasis added.)

According to the reasoning of the Court, useful life can be terminated only by the completion of the process of physical exhaustion from wear and tear.

It is significant that in each of the cases we have cited, the Commissioner took the position that the useful life of depreciable property *was a period substantially longer than the taxpayer's holding period.* One may well ask why the Commissioner now takes a position in this and other recent cases which is novel when viewed in the light of his past rulings in this field. We believe the answer is clear, and shall discuss it hereinafter at pages 31-36 of this Brief.

(e) The facts and expert testimony.

At the trial, petitioner called two expert witnesses, certified public accountants who are members of two of the outstanding accounting firms in the nation, Ernst & Ernst and Price Waterhouse & Co. Their testimony was based on their many years of cumulative experience in public accounting.

Drawing on this experience in applying the depreciation provisions of the Federal income tax law and respondent's own regulations, both testified that the term "useful life" has the same meaning for the purposes of fixing depreciation rates for tax purposes as it has in general accounting practice. Both testified that the term "useful life" means the economic or the physical life of a particular asset. Furthermore, both testified that in their dealings with representatives of the Internal Revenue Service with respect to allowances for exhaustion, wear and tear of depreciable assets, those representatives have applied the same meaning to the term "useful life" as was generally understood in their accounting practice (R. 85, 86, 89, 90).

It is significant that the respondent failed to offer any evidence to contradict the testimony of petitioner's experts

on this point. Furthermore, the record shows that their testimony remained unimpeached after respondent's cross-examination (R. 86-88, 90-92).

It is well established that testimony of expert witnesses as to the correctness and prevalence of the administrative interpretation of a phrase involving an accounting concept, such as "useful life", is particularly pertinent. It has been recognized as such by the Supreme Court of the United States in *Willcuts* v. *Milton Dairy Company,* 275 U.S. 215 (1927), where the ordinary business meaning ascribed to a corporate accounting phrase was held to provide an authoritative interpretation of that phrase as used in the Revenue Act of 1918. The Supreme Court of the United States quoted this doctrine with approval as recently as June 9, 1958 in *The Colony, Inc.* v. *Commissioner of Internal Revenue,* No. 306, October Term, 1957, 58-2 USTC Para. 9593:

> ". . . statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

Using the vantage point of the present, not of the dates when tax returns had to be filed, the Tax Court has looked back over the years 1950 and 1951 and on the basis of what is known today states that the average period of use of cars by petitioner was a given number of months. But that fact —now easily ascertainable—does not justify the holding that that average period of use was "useful life" for depreciation purposes.

The fact is that the *only evidence* in the record before this Court is that the factors affecting the holding periods of petitioner's automobiles were too varied and too unpredictable to enable any precise normal holding period to be determined. The only testimony offered shows incontestably that in petitioner's past experience wide fluctuations in holding periods are to be expected.

Respondent surely cannot require a taxpayer to make out his income tax return each year taking depreciation on the basis of his past experience—and then, at the end of each two- (or three- or four-) year period, to review his experience for that specific two- (or three- or four-) year period only, and file amended returns; and again at the end of the third (or fourth or fifth) year, file amended returns for the year (or two or three years) preceding. Surely the Commissioner cannot ask the Court to accept so chaotic a solution to the problem he raises. The only sound alternative is that which has been accepted for years by the Commissioner and by taxpayers: to determine at the time such assets are acquired the period of time the taxpayer may reasonably expect the assets to be *used or usable for general business purposes.* The taxpayer should not be required to wait for years in order to determine useful life on the basis of such hindsight as is now available to respondent's counsel for the taxable years 1950 and 1951.

The useful lives of 15 months and three years found by the Tax Court do not stand up under analysis. These figures happened to be the average holding periods of petitioner's cars sold during the two taxable years 1950 and 1951. Statistics to determine the particular average figures selected by the Tax Court were not available until *many months after the cars were purchased.* In some instances, the useful life cannot be determined until *several years after the purchase of the cars.* And what is so particularly compelling about using a two-year experience? The fact that there happen to be two tax years in issue here does not mean that two years (or any given number of years) is a meaningful control period.

The only evidence before this Court on the meaning of the term "useful life" is the experience of the taxpayer's witnesses, in dealing with Internal Revenue Agents in the field under the 1939 Code, that useful life meant general business life, not life in the hands of the individual taxpayer (R. 85, 89). And the position taken by the Commissioner in the decided cases (heretofore discussed) was contrary to his present position. The Commissioner's position in those cases was certainly known both to the accountants and to the agents working in the field. If respondent's counsel had been able to show that this was not the case, he could readily have called supporting witnesses from the government agency in possession of full knowledge of the facts—the Internal Revenue Service.

II.

The term "salvage value" of property, for depreciation purposes, means the residual, junk or scrap value of property remaining after the end of its "useful life", as defined above. It does not mean the estimated proceeds which may be realized from the disposition of the property when a taxpayer dispenses with it as income-producing property in his particular business long before the end of its useful life.

The meaning of "salvage value", for depreciation purposes, emerges inevitably from the preceding discussion of "useful life". It is the residual, junk or scrap value of property left after the end of its physical "useful life." "Salvage value" is not the estimated proceeds which may be realized from the disposition of the property when a taxpayer dispenses with it as income-producing property in his particular business before the end of its useful life.

In accordance with respondent's Regulations 111, Section 29.23(l)-1, depreciation over the useful life plus salvage value equals cost. Thus, salvage value must be the reciprocal of useful life—the value remaining at the expiration of the inherent physical life of property, which, as we have demonstrated above, is the proper definition of "useful life". It is that part of the value of property which can never be destroyed by depreciation of the property, that is, by exhaustion, wear and tear. The testimony of qualified expert witnesses shows that the business community regards salvage value as having such a meaning (R. 85, 87, 89, 90).

Recently, a decision of the United States District Court in Nebraska has applied the established rule with respect to the meaning of "salvage value" for depreciation purposes. In *Lydia P. Koelling, et al.* v. *United States* (D.C.D. Neb., Grand Island Div., 2/14/57, 57-1 USTC Para. 9453), it was shown that certain bulls, held in a breeding herd, were sold either to other breeders or for slaughter. Despite the fact that the bulls sold to other breeders, and thereafter used by the latter for breeding purposes, brought substantially higher prices than they would have if sold for slaughter, the court, in determining the depreciation applicable to the bulls before sale, held that the salvage value to be taken into account was their value as "slaughter" or "sausage" bulls. This value was equivalent to the scrap value we have referred to above—the value which can be realized when the asset is worn out and fit only for scrapping or conversion to a use substantially different from its original, intended use.

Respondent contended before the Tax Court that petitioner's average useful life for his automobiles matched petitioner's average holding period of 17 months and that

salvage value was $1,325, the average sales proceeds received for automobiles sold 17 months after acquisition. The Tax Court decided that the average useful life of leased automobiles was 3 years and that the average useful life of rented automobiles was 15 months. The Tax Court, *using the sales proceeds theory* of salvage value, set respective salvage values at $600 and $1,375.

The claim that salvage value is measured by, or has any relation to, sales proceeds was effectively laid to rest many years ago because it was contrary to logic and authority. For example, in *Reginald Denny,* 33 BTA 738 (1935), the Board of Tax Appeals stated:

> "From the [taxpayer's] testimony, we gather that he regarded shrinkage of market value as synonymous with loss of useful value. *The two are rarely, if ever, the same.*" (33 BTA, at 743; emphasis added.)

If, as petitioner contends and the authorities indicate, four years is the useful life of automobiles used by petitioner, the salvage value of those automobiles for depreciation purposes is their value *after four years of use.* Neither respondent nor the Tax Court has contended, cited evidence, found as fact, or held, that such value is anything other than as claimed by petitioner. The Tax Court's determination of salvage value is apparently based only on its unsupported definition of useful life.

III.

The respondent's redefinitions of useful life and salvage value are intended to nullify Section 117 (j) of the 1939 Code.

The redefinitions of "useful life" and "salvage value" tacitly assumed by the Tax Court below would require each taxpayer to make estimates of his own probable holding period of each of his depreciable assets and the probable sales price realizable at the end of that holding period. Because of the highly subjective and individual nature of these estimates, the possible area of contention between taxpayers and revenue agents would be greatly broadened. This is not a hypothetical difficulty. We submit that the respondent and the Tax Court have no authority, without the authority of legislation, to substitute, retroactively, a new subjective rule as a substitute for an objective rule which has had the force of law for over forty years.

It has been respondent's consistent policy in the past to *avoid* subjective judgments in the depreciation field. See, for instance, Rev. Rul. 90, 1953-1 CB 43 and Rev. Rul. 91, 1953-1 CB 44. No basis has been shown for upsetting the long-standing rule set forth in respondent's own regulations, Regulations 111, Section 29.23 (l)-1.

In the light of all the foregoing, what is the motive of the Commissioner in attempting to reverse established policies?

It seems clear that what the Commissioner is attempting to do in this case is to assert a new definition of "useful life" which, in conjunction with his new definition of "salvage value", would mean that, generally speaking, *taxpayers would not be able to avail themselves of capital gains* upon the sale of business assets under Section 117(j) of the 1939 Code.

Respondent in his deficiency notice (R. 12) originally contended that any gain realized by petitioner from the sale of his automobiles was includible in petitioner's returns not as capital gains, as reported by petitioner, but as ordinary income—on the theory that petitioner was a dealer in automobiles. In his brief before the Tax Court, respondent abandoned that contention and conceded the petitioner's right, under Section 117(j) of the 1939 Code, to treat sales of his automobiles as sales of property used in petitioner's trade or business, not held primarily for sale to customers in the ordinary course.

That concession is meaningless if this Court accepts the respondent's new definitions of useful life and salvage value. Petitioner submits that this concession confirms that respondent's argument in this case is designed to achieve the informal repeal of Section 117(j) and its successor provision in the 1954 Code, Section 1231. Indeed, respondent's counsel admitted as much at the hearing before the Tax Court when he stated:

> " . . . our position is somewhat in the alternative because we have adjusted the useful life and we have adjusted the depreciation and in taking that action we have cut down the amount of gain or profit considerably." (R. 40.)

Respondent's true objective here is to defeat the application of Section 117(j) and, in defiance of Congressional purposes, to prevent the realization of capital gains thereunder. If that result cannot be effected in any other way, then it must be done by way of eliminating any recovery beyond cost, upsetting the accepted definition of useful life, imposing an arbirtary salvage value limitation upon the taking of depreciation—*anything* to defeat the express statutory mandate that gains on the sale of business property shall be taxed at capital gains rates.

In the light of the legislative history subsequent to enactment of Section 117(j), it is astonishing to see the Commissioner continuing his efforts arbitrarily to nullify that Section. Section 117(j) of the 1939 Code was carried through into Section 1231 of the 1954 Code, so that in 1954, Congress, reaffirming twelve years of experience with the former statute, again provided for capital gains treatment of profits resulting from the sale of depreciable property used in the taxpayer's trade or business and held for more than six months. Congress made it clear that its earlier provision in the 1939 Code for capital gains treatment of profits on the sale of business property was not being disturbed. Page A275 of House Report No. 1337, 83rd Cong., 2d Sess., states, with respect to Section 1231:

> "This section is derived from section 117(j) of present law. There is no substantive change intended but some rearrangement has been made."

During the extensive Revenue Revision hearings held by Congress in 1947 and 1948, the Business Tax Section of the Division of Tax Research of the Treasury Department submitted a report on accelerated depreciation to the Ways and Means Committee of the House of Representatives ("Revenue Revisions, 1947-1948", hearings of December 2-12, 1947, Part 5, page 3756), in which the Treasury Department *attempted to reduce the effect of the capital gains section* in the 1939 Code [Section 117(j)]:

> "[A] danger is that accelerated depreciation allowances might be used to convert ordinary income into capital gains, since a businessman might sell a fully depreciated asset that still had a substantial value, paying a tax on the capital gain and avoiding the taxes on its income that were deferred during the period of accelerated depreciation. This type of avoidance could be overcome by requiring that if the taxpayer elects to use accelerated depreciation, gain to the extent of the excess of accelerated over normal depreciation must be treated as ordinary income."

That was an initial attempt by the Treasury Department to attack the benefits of capital gains treatment of profits realized from the sale of assets subject to depreciation. The attempt failed because the philosophy of Congress was to encourage capital investment, to encourage the sale of capital assets and thus to encourage the purchase of new capital assets.

Shortly thereafter, the Treasury Department took a different approach in its attack on Section 117(j). It recommended to Congress in 1950 that losses on the sale of depreciable business property be treated as capital rather than ordinary losses. This recommendation was rejected. (See committee reports on H.R. 8920, 81st Cong., 2d Sess.)

Still another attempt by the Treasury Department to eliminate capital gains in connection with the sale of depreciable property came some time ago when the Treasury Department apparently decided that, having lost its battle in Congress, it would nevertheless try to get the same result in another way—by attempting to disallow capital gains in this type of case by contending, under Section 117(j) of the 1939 Code, that the assets in question were held "primarily for sale to customers in the ordinary course of [taxpayer's] trade or business" and thus were ineligible for capital gains treatment under that Section.

That attempt also failed. That approach was closed off by the courts in *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3rd, 1956), and also in *Massey Motors, Inc.* v. *United States,* 156 F. Supp. 516 (D.C.S.D. Fla., 1957), which we have discussed above, at pages 21-23. In subsequent cases, apparently the Treasury Department has simply dropped its contention that vehicle renters or lessors are dealers in automobiles; and, as noted above, respondent eventually abandoned that issue in this case.

However, the Commissioner apparently believes that he may have found another approach, a back door through which he may be able to strike down or substantially impair capital gains treatment of profits from the sale of depreciable business assets. That new-found way, in the case of business automobiles, is to claim that the useful life of such automobiles is not the usual and accepted period of four years, but whatever may turn out to be the holding period of the particular taxpayer under examination. With the imposition of this definition of useful life, and with salvage value arbitrarily defined as meaning whatever the taxpayer happens to get for an automobile at the end of a year and a half or two years, there is relatively little asset value subject to depreciation and there is no capital gain.

Moreover, we submit the following as one of the most significant items in the legislative history of this subject: When Congress was debating the 1954 Code, the question of capital gains on the sale of business property was specifically brought to the attention of Congress by the Committee on Federal Taxation of the American Institute of Accountants. On April 19, 1954, that group filed with the Senate Finance Committee its Recommendation No. 180 with respect to Section 1231 (Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2d Sess., on H.R. 8300, Part 3, page 1324), as follows:

> "Gain or loss on property used in the trade or business, etc., should be treated uniformly as ordinary income or loss."

That recommendation was heard and disregarded. In fact, in the face of that recommendation to cut off capital gains on the sale of business property, Congress re-enacted in 1954 the same capital gains principle as had previously been enacted in Section 117(j) of the 1939 Code.

In view of Congress's clear intention, we submit that respondent in the case at bar is obviously trying, by attempted administrative legislation, to do what Congress refused to do when that very question was specifically put before it.

In this connection, it is interesting that Congress did see fit, in connection with rapid amortization of emergency facilities (Section 168 of the 1954 Code [formerly Section 124A of the 1939 Code] and Section 1238 of the 1954 Code [formerly Section 117(g)(3) of the 1939 Code]) to limit capital gains on sales of emergency facilities amortized under Section 168.

But Congress did not enact any capital gains limitation in connection with its enactment of Section 23(l)—the section here involved.

It seems probable that if this Court should affirm the deficiencies determined below, any taxpayer reporting gain on the sale of a depreciable asset under Section 117(j) or Section 1231 may expect to be met with the claim that the particular holding period and the particular selling price established the useful life and salvage value which should have been used in the depreciation account in the first instance. The practical result would be the effective administrative repeal of Section 117(j) and Section 1231, in disregard of the clearly expressed intention of Congress.

Whether the policies implemented by those Sections are to continue to govern taxpayers is an issue for Congress, not the respondent or the Tax Court, to decide.

IV.

The three decisions cited by the Tax Court, in its opinion below, do not support its conclusion.

The opinion of the Tax Court, cast in memorandum form (reported at 16 TCM 639) not only ignored the firmly established legal interpretation and administrative practice summarized above, but also, in view of the absence of meaningful legal analysis or authority, appears simply to have adopted and assumed the correctness of the novel theory of the respondent. The Tax Court completely ignored petitioner's arguments, as evidenced not only by its failure to discuss them in any way in its opinion, but by its failure to mention a single one of the many authorities (statutes, regulations, cases, rulings and items of legislative history) cited by petitioners in their briefs (see Dickinson, ''Useful Life and Salvage Value: Changing Concepts,'' 7 Drake L. Rev. 32 [December, 1957]).

The Tax Court merely *assumed, without discussion,* that petitioner's average holding period of, and average sales proceeds from, his automobiles during the particular years in controversy constituted, respectively, their useful life and salvage value. In so holding, the Tax Court rejected the entire past development of principles underlying the depreciation deduction without even an acknowledgment of the fact that those principles were at stake.

The Tax Court appears to have been unaware of, or to have merely ignored, the basic issues and the revolutionary change in concepts embodied in its simple acceptance of respondent's position herein. This acceptance amounts to establishment of a far-reaching principle without any meaningful analysis of the issues at bar.

In its memorandum decision, the Tax Court made the following finding of fact:

> "The surplus automobiles sold by Robley [petitioner] could have been used longer than they were; . . . "
> (R. 28)

This finding of fact by the Tax Court clearly raised a question of *law* which should have been considered by that court in its opinion. That question of law has been presented to this Court, and may be briefly restated here: As a matter of law, does the term "useful life" for depreciation purposes mean the period during which a particular taxpayer holds a business asset or does it mean the physical life of such asset? *In its opinion, the Tax Court did not consider this question of law raised by its own finding of fact.*

In reaching what we believe to be an unreasoned and in fact unreasonable conclusion with respect to this pure question of law, the Tax Court cited without discussion only three decisions. None of these, we submit, is in point. Indeed, instead of supporting the propositions necessary to sustain the Tax Court's decision, they are consistent with the traditional definitions applied by the petitioner in computing depreciation during the taxable years in issue.

The first case cited by the Tax Court is the Supreme Court's decision in *United States* v. *Ludey*, 274 U.S. 295 (1927) (R. 31). This case dealt solely with the determination of the correct basis for gain or loss on the sale of oil-producing property, including equipment used in connection with the production of oil from such property. The decision was cited by the Tax Court only because it gave, in passing, a judicial expression to the depreciation formula found in the Commissioner's regulations since 1918.

To bring more clearly into focus the context in which the Supreme Court was applying that formula, we need only refer to the language of the Court found at page 301:

> "The theory underlying this allowance for depreciation is that by *using up* the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets." (Emphasis added.)

Preceding the above-quoted portion of the Supreme Court's opinion, the Supreme Court had said in the same paragraph (page 300):

> ". . . The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through *wear and tear* of the plant used. . . ." (Emphasis added.)

This statement of the Court, quoted above, clearly relates depreciation to a physical life, a physical using up of the asset, and furnishes no support to the respondent's theory.

The Tax Court also cites in its opinion herein *Leonard Refineries, Inc.,* 11 TC 1000 (1948), Acq. 1949-2 CB 2 (R. 31). In that case, taxpayer attempted to increase its excess profits tax credit (computed under the income method) by decreasing its depreciation allowance for a base period year. It was taxpayer's position that certain desalting equipment, which it began to use two years after it set up its schedule for depreciating its refinery equipment, would

extend the term of the physical or useful life of the refinery equipment. The Tax Court rejected this claim only because the taxpayer failed to prove that the use of a desalter lengthened the *physical life* of the refinery equipment. Thus, even while rejecting the taxpayer's claim for lack of evidence, *the Tax Court was defining the term "useful life" as does petitioner herein—as physical or economic life*—stating, at page 1008:

> "We do not think the fact that a desalting unit was effectively operating at the Alma plant in 1938 makes the 1940 depreciation rates on the six classes of assets unreasonable simply because this factor was not considered in originally fixing these rates. There is no evidence that such a machine *prolonged* the useful lives of either nonproduction assets or production equipment which did not come into *actual contact* with the crude oil. Further, the desalter had no effect on the sulphur compounds in the Michigan oil, which were the most important corrosive element. We have no basis in the facts for calculating how much it *reduced the total corrosion* inherent in the refining process . . . ." (Emphasis added).

The second issue in that case confirms again the proper definition of the term "useful life". That issue involved the contention of the taxpayer that it was entitled to take depreciation on certain assets based on *the physical lives of those assets* rather than over the term of a particular lease. On this issue, the Tax Court stated, at page 1009:

> ". . . We hold that the depreciation rates for 1939 and 1940 should have been based on *the physical lives* of these assets because of circumstances known to petitioner on March 31, 1939, the close of the fiscal year 1939." (Emphasis added.)

With respect to both issues involved in the *Leonard Refineries* case, the Tax Court explicitly equates useful life with physical life. It is clear, therefore, that this case, cited by the Tax Court below, is not authority for the holding of that court.

The only other case cited in the Tax Court's opinion is *J. W. McWilliams,* 15 BTA 329 (1929), Acq. VIII-2 CB 34 (R. 33). It is cited at the end of that opinion, and appears to be intended to buttress the position taken by the Tax Court that the useful life of petitioner's automobiles is equivalent to petitioner's holding period, and that salvage value is equivalent to the proceeds realized from the sale of petitioner's automobiles at the end of that holding period. No such authority can be found in or implied from the *McWilliams* case. Indeed, this case supports petitioner's position and the established practice.

Two depreciation issues were involved in the *McWilliams* case. The first concerned a lumber mill which had a physical or economic life of ten years. Unfortunately, it was located in a timber tract where all of the lumber would be exhausted in six and one-half years, which the taxpayer claimed was its useful life. The Board of Tax Appeals might have said that useful life, for purposes of computing depreciation on the mill, was the period of anticipated actual use by the taxpayer (the respondent's position in the present case); instead, the Board *ignored the taxpayer's period of anticipated use* and utilized the inherent physical or economic life of the mill. The Board specifically rejected a useful life based upon the likelihood that the adjacent timber would be exhausted within a given period, stating:

> "We have found that the *physical life* of the mill and plant was 10 years. . . .
>
> ". . . We can not say that the plant will not operate its full 10 years of life. . . . We hold an allowance of 10 per cent for depreciation for the years 1920 and 1921 to be reasonable and proper." (15 BTA, at 339, 340; emphasis added.)

The Board specifically rejected, as a test for useful life, the period of probable actual use of the property by the taxpayer, and employed instead the physical life of the

property. The Board reasoned that adverse market conditions might require the taxpayer to use the property for its full physical life.

In the case at bar, petitioner was governed not only by market conditions in determining his holding periods, but also by many other factors affecting his holding period of automobiles. These factors included competitive developments, technical improvements of automobiles, the possibility of war and restricted automobile production, lease term duration and variations in automobile supply (R. 65, 66, 69, 71). These factors were unpredictable at the time petitioner acquired his automobiles, and were clearly beyond his control. The rationale of the Board's decision in the *McWilliams* case, where only one unpredictable factor was involved, is even more forcefully present in the petitioner's case.

The Board was also called upon to decide in the *McWilliams* case an issue involving the depreciation of taxpayer's business automobiles. The meaning of the terms "useful life" and "salvage value" was not involved in that issue. The Board simply had to determine the amount and annual allocation of the depreciation allowable on automobiles which were acquired and traded in during a four-year period. The taxpayer did not maintain any depreciation schedules for the automobiles while he owned them; consequently, there was not available to the Board any of the customary depreciation data. Under the circumstances, the Board allowed depreciation on the basis of the initial cost of the original two cars, plus subsequent cash payments for new cars, less the resale value of the last car used, prorated over the years of the business's use of the automobiles. The Board specifically pointed out that it had no alternative, since no evidence had been introduced as to proper depreciation, and *limited its holding to the situation where no depreciation schedules were maintained,* stating, at p. 345:

"... *In the absence of evidence as to just when the exchanges of cars were effected and the details of those transactions,* we hold that the total of this *exhaustion* should be apportioned ratably over such period. ..." (Emphasis added.)

The Board in the *McWilliams* case, it should be noted, referred to depreciation as a process of *exhaustion,* that is, a process of physical consumption of property. Further, the Board stated, at page 344:

"... The record shows that beginning early in 1920 petitioner used exclusively for business purposes two automobiles which he had purchased. It follows that actual depreciation sustained upon these automobiles as a result of this business use, if it can be determined, is a proper deduction from gross income as *wear and tear* on assets used in trade or business. ..." (Emphasis added.)

We submit that this analysis of the three decisions cited by the Tax Court in its opinion below demonstrates that those decisions not only do not support the conclusion reached by the Tax Court, but actually support the position taken by the petitioner herein.

Continuing our analysis of the Tax Court's opinion below, we shall next review it in the light of the statute and the regulations in effect for the taxable years in issue.

The position taken by the Tax Court below, substituting a test based on petitioner's holding period and his assumed intent for a test based on physical exhaustion, wear and tear, is inconsistent with the language of Section 23(l) of the 1939 Code and the respondent's regulations thereunder, particularly Regulations 111, Section 29.23(l)-1, in which respondent states:

"A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, ... may be deducted from gross in-

> come. For convenience such an allowance will usually be referred to as depreciation, *excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. . . .*" (Emphasis added.)

An analysis of the Tax Court's opinion and the respondent's position will demonstrate the above-mentioned inconsistency. The test applied by the Tax Court below did not conform to the test set out in the 1939 Code and the regulations. The test of the Code and regulations is based on the annual loss of value resulting from exhaustion and wear and tear, which are physical facts, but the Tax Court instead adopted for depreciation purposes a test based on the mere *loss in market value* during the period petitioner held his automobiles, contrary to such cases as *Reginald Denny,* 33 BTA 738 (1935). Under the theory of the Tax Court's opinion in the case at bar, the starting point in determining the amount of depreciation allowable is the amount realized by petitioner on the disposition of his automobiles. However, it is clear that the amounts realized by petitioner on the disposition of his automobiles were not determined by the physical facts of the exhaustion and wear and tear of his automobiles. They were basically determined by reference to the automobile dealers' handbook of values (N.A.D.A. book), which is revised monthly (R. 58, 60.) The amounts realized by petitioner were merely whatever happened to be the market values at a particular period of time in the physical life of the cars.

After reducing petitioner's cost by the amount he realized on resale of his automobiles, the Tax Court directs that the resulting balance be deducted over the term of petitioner's holding period as a depreciation allowance. That, says the Tax Court, is the measure of petitioner's depre-

ciation. This whole concept, we submit, is merely an application by the Tax Court of the test *prohibited* under the applicable regulations: the deduction as depreciation of an amount which represents the mere loss in market value *without regard to* the exhaustion or wear and tear of the asset.

Conclusion.

In summary, petitioners' position is that the testimony in this case, the decisions in tax cases directly in point, and the Commissioner of Internal Revenue himself in his own pronouncements—all lead to these conclusions:

(1) that petitioner's automobiles have a useful life determined by the period of their physical usefulness for business purposes and a salvage value determined by their residual or scrap value at the end of such period;

(2) that a four-year useful life and a nominal scrap value are established by the record in this case; and

(3) that the decision of the Tax Court has no support in the record or in the decisions for applying different definitions and deriving different figures for the useful life and salvage value of petitioner's automobiles.

Petitioners respectfully request that the Tax Court's conclusions herein with respect to allowable automobile depreciation during 1950 and 1951 be reversed and that the

depreciation allowance claimed on petitioners' returns for those years be sustained.

Roswell Magill
15 Broad Street
New York, New York

Lyle L. Iversen
800 Hoge Building
Seattle, Washington

Edgar Bernhard
33 North La Salle Street
Chicago, Illinois

Donald J. Yellon
33 North La Salle Street
Chicago, Illinois

John C. Klett, Jr.
15 Broad Street
New York, New York
Attorneys for Petitioners.

Of Counsel:

Cravath, Swaine & Moore
15 Broad Street
New York, New York

D'Ancona, Pflaum, Wyatt & Riskind
33 North La Salle Street
Chicago, Illinois

APPENDIX A

Statute and Regulations Involved.

Section 23(l), 1939 *Code* (*Title* 26, *United States Code, Section* 23[l]):

"In computing net income there shall be allowed as deductions:

* * *

"(l) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income. . . ."

[*Note*: The remainder of Section 23(l) deals with allocation of depreciation between life tenant and remainderman and between income beneficiaries and trustee, and has been omitted because it is not relevant to the issues herein.]

Regulations 111, *Section* 29.23(l)-1:

"Depreciation.—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable

property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. . . . ''

[*Note*: The remainder of this section deals with allocation of depreciation between life tenant and remainderman and between income beneficiaries and trustee, and has been omitted because it is not relevant to the issues herein.]

APPENDIX B.

Record References To Exhibits.

(Pursuant to Rule 18[2][f] of the Rules of the United States Court of Appeals for the Ninth Circuit.)

Exhibit	Identified, Offered and Received in Evidence at Record Page
Petitioner's Exhibit 5	[Not referred to in printed record.]
Petitioner's Exhibit 9	44
Petitioner's Exhibit 10	56, 57
Petitioner's Exhibit 11	56, 57
Petitioner's Exhibit 12	68
Respondent's Exhibit A	[Not referred to in printed record.]
Respondent's Exhibit B	
Respondent's Exhibit C	
Respondent's Exhibit D	
Respondent's Exhibit E	
Respondent's Exhibit F	